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Cases, Regulations, and Statutes

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CASES, REGULATIONS AND STATUTES

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ADVERSE POSSESSION

FENCE. The plaintiff's farm and defendant's farm were separated by a railroad right of way which was abandoned by the railroad. The defendant's title included the right of way within the defendant's property. The plaintiff constructed a fence on the defendant's side of the right of way and claimed that the fence created a boundary sufficient to pass title to the right of way to the plaintiff when the railroad abandoned the right of way. However, the plaintiff admitted that the land on the defendant's side of the right of way was not used for pasturing cattle until the railroad stopped running trains on the right of way, an event which occurred only six years before the right of way was abandoned. The court also noted that there was no agreement between the parties that the fence would serve as a boundary line between the properties. The court held that the plaintiff did not acquire title to the right of way by means of adverse possession or by establishing a boundary fence. **Francis v. Rogers, 40 P.3d 481 (Okla. 2001)**.

BANKRUPTCY

FEDERAL TAX-*ALM* § 13.03[7].*

DISCHARGE. The debtor was an anesthesiologist who filed for Chapter 11. The debtor failed to file returns and pay taxes for almost 20 years although the debtor was aware of the need to file and pay taxes and had substantial income and assets available to pay the taxes. The debtor made a few tax payments in order to release tax liens on property. During this time the debtor made substantial gifts to family members and transferred assets to entities which made the assets unreachable by IRS liens. The debtor also maintained substantial personal expenditures for vacations. The debtor eventually filed the returns and made some payments under orders of courts. The court held that, under Section 523(a)(1)(C), the taxes were not dischargeable because the debtor willfully attempted to evade the payment of the taxes. ***In re*** **Eleazar, 271 B.R. 766 (Bankr. D. N.J. 2001)**.

The debtor failed to file income tax returns or pay taxes for two years. The IRS assessed the taxes after constructing substitute returns. The court held that the substitute returns were not considered returns for purposes of Section 523(a)(1) and the taxes were nondischargeable. ***In re*** **Thompson, 272 B.R. 612 (D. Md. 2002)**.

PREFERENTIAL TRANSFERS. Within the 90 days before the debtor filed a Chapter 7 petition, the debtor received an income tax refund loan in which the debtor received funds in exchange for assigning a tax refund to the lender. The agreement provided for the debtor to establish an account with the lender which was used for designating the receipt of the refund from the IRS. The lender retained control over the account and transferred the funds to its own accounts immediately after the refund was received. The Chapter 7 trustee sought to avoid the transfer of the funds in the account as a preferential transfer. The court held that the transfer was not a preferential transfer because (1) the transfer was made in the ordinary course of business and (2) the transfer was a recoupment. The court stated that, although the debtor only had one business transaction with the lender, the transfer of the funds from the account to the lender was made within the whole business transaction. Thus, the court expanded the ordinary course of business exception to include a single set of related transactions instead of a business relationship established over time and several transactions. The court noted a split among the courts which have decided this issue. **Warsco v. Household Bank F.S.B., 272 B.R. 246 (Bankr. N.D. ind. 2002)**.

CONTRACTS

ARBITRATION CLAUSE. The debtor was a farmer and had entered into several hedge-to-arrive contracts with a grain cooperative. The debtor defaulted on three of the contracts and the cooperative demanded damages from the debtor. The contracts contained provisions requiring arbitration before the National Grain & Feed Ass'n (NGFA). The debtor refused to submit to arbitration and the cooperative obtained a state court order forcing arbitration. In the arbitration proceeding the debtor claimed that the contracts were void as illegal, off-exchange futures contracts. The arbitrators ruled that the contracts were valid cash forward contracts and awarded damages to the cooperative. The debtor filed for bankruptcy and the cooperative filed a claim for the damage award. In the bankruptcy case, the debtor attempted to attack the validity of the arbitration proceeding as biased because of the predominance of grain dealers on the arbitration panel. The court held that the debtor failed to provide sufficient evidence of bias in the arbitration process. The court also held that the arbitration award was due preclusive effect, barring the Bankruptcy Court from relitigating the validity of the contracts. ***In re*** **Robinson, 265 B.R. 722 (Bankr. 6th Cir. 2001), *aff'g*, 256 B.R. 482 (Bankr. S.D. Ohio 2000)**.

SPECIFIC PERFORMANCE. The plaintiffs leased farm land from the defendant for one crop year. The lease provided for termination after harvest or by November 1 at the latest. The lease also gave the plaintiffs an option to purchase the property at its appraised value or an agreed upon price. The plaintiffs harvested the crop in October and gave the defendants a written exercise of the option on October 31. The plaintiffs also testified that they had given an oral notice of the exercise of the option during the summer. The defendants refused the offer as untimely because the lease

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had expired. The plaintiffs sought specific performance of the option to purchase. The defendants argued that specific performance was not appropriate because the contract was too indefinite. The court noted that the lease had no provisions specifying the method required for exercising the option. The court held that the oral notice was sufficient to exercise the option. The defendants argued that the contract was too indefinite as to the price to be enforceable. The court held that the provision for a price based on an appraisal was sufficient to support specific performance of the option. The court also held that specific performance was proper where no other remedy was available. The plaintiffs testified that the farm was attractive to them because it was close to other farmland owned by the plaintiffs and had soil needed to grow the crops produced by the plaintiffs. **Schreck v. T & C Sanderson Farms, Inc., 37 P.3d 510 (Colo. Ct. App. 2001)**.

FEDERAL AGRICULTURAL PROGRAMS

No new items.

FEDERAL ESTATE AND GIFT TAX

LIFE INSURANCE. The decedent was a partner in a partnership composed of the decedent, the decedent's brother and an unrelated person. The partnership owned real property which was leased to a corporation also owned in part by the decedent and the decedent's brother. The partnership owned a life insurance policy on the life of the decedent and the partnership agreement provided for payment of the life insurance proceeds to the partnership and the partnership purchase of the decedent's partnership interest. The IRS ruled that the life insurance proceeds were paid for the benefit fo the partnership and were not included in the decedent's gross estate under I.R.C. § 2042. **Ltr. Rul. 200214028, Jan. 7, 2002**.

VALUATION OF STOCK. The decedent owned a 49 percent interest in a corporation which operated a hair salon products business under the decedent's name. The Tax Court had valued the full company at fair market value with a discount for the loss of the decedent to the company. The Tax Court also discounted the value of the stock by 35 percent for a minority interest and lack of marketability. Finally, the Tax Court discounted the value of the stock by 15 percent because of a pending lawsuit. The appellate court reversed, holding that the Tax Court failed to provide sufficient support for the valuations and discounts applied. On remand the Tax Court discounted the value of the stock by 35 percent for a minority interest and lack of marketability and an additional 10 percent for the loss of the decedent. Instead of applying a disocunt for the pending litigation, the Tax Court reduced the value by $1.5 million. **Estate of Mitchell v. Comm'r, T.C. Memo. 2002-98, *on rem. from*, 250 F.3d 696 (9th Cir. 2001), *rev'g in part*, T.C. Memo. 1997-461**.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued procedures under I.R.C. §§ 446 and 471 that will allow qualifying small business taxpayers with average annual gross receipts of less than $10 million for the last three years to use the cash receipts and disbursements method of accounting with respect to eligible trades or businesses. The procedures will not apply to farming businesses. **Rev. Proc. 2002-28, I.R.B. 2002-18**.

CAPITAL EXPENSES. The IRS has modified TAM Ltr. Rul. 200043016, July 14, 2000 and TAM Ltr. Rul. 200203013, Oct. 9, 2001 to conform with *Rev. Rul. 2002-9, I.R.B. 2002-10, 614*. The revenue ruling provided that impact fees incurred by real property developers in connection with the construction of a new residential rental building are indirect costs that, pursuant to I.R.C. §§ 263(a), 263A, should be capitalized and added to the basis of buildings constructed. Accordingly, developers and operators of low-income housing may include such fees in the computation of the low-income housing credit. **TAM Ltr. Rul. 200216027, March 11, 2002**

CORPORATIONS-*ALM* § 7.03.*

CONSTRUCTIVE DIVIDENDS. The taxpayer was a corporation which owned and operated a country club. The corporation charges fees for use of the facilities and equipment and for food and provides a percentage discount to shareholders, many of whom own housing nearby. The corporation did not declare or pay dividends to the shareholders. The IRS ruled that the discount amount was a constructive dividend to the shareholders. **Ltr. Rul. 200215036, Jan. 11, 2002**.

ENROLLED AGENTS. The IRS has announced that the expiration date for current enrolled agent cards, which was set for March 31, 2002, has been extended to April 30, 2002. **ANN. 2002-41, I.R.B. 2002-14, 739**.

LIKE-KIND EXCHANGES. The taxpayers, husband and wife, purchased a residence and used it as their primary residence for several years. The taxpayers purchased another residence and converted the first residence into a rental property. The fair market value of the property was much less than the taxpayers' adjusted basis in the property at the time of the conversion. The rental property was then exchanged for another rental property. The fair market value of the taxpayers' property was almost double the fair market value of the property received. The court held that (1) the taxpayers' basis in the first rental property was the fair market value at the time of the conversion, (2) the adjusted basis of the exchanged property was the adjusted basis of the first property less the difference in fair market value, considered boot, between the exchanged properties. **Bundren v. Comm'r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,331 (10th Cir. 2002), *aff'g*, T.C. Memo 2001-2**.

PARSONAGE EXEMPTION. Legislation has been introduced and passed in the U.S. House of Representatives which clarifies the exemption for the fair rental value of housing provided to ministers to include furniture and the cost of utilities. The legislation was in response to Warren v. Comm'r., No. 00-71217, 2002 U.S. App. LEXIS 3420 (9th Cir. Mar. 5, 2002) which held that the parsonage exclusion for a minister was the actual amount used to provide a home, not the fair market rental value of the home. The next issue of the *Digest* will publish an article on this case and legislation by Roger McEowen and Neil Harl. **H.R. 4156**.

PARTNERSHIPS-*ALM* § 7.03.*

PARTNERS**.** The taxpayer held the position of Of Counsel for a partnership which provided legal services. The taxpayer was paid a fee which did not depend upon the profits of the partnership and the partnership treated the compensation as a guaranteed payment. The IRS ruled that the taxpayer was not a partner and the payments were incorrectly classified as guaranteed payments. **CCA Ltr. Rul. 200215053, No date given**.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, were owners of an S corporation which provided management services for several pass-through entities owned in part by the taxpayers. The pass-through entities paid the corporation a management fee which was paid to the taxpayers for their services to the corporation. The taxpayers also reported their share of the management expense from the several pass-through entities. The taxpayers argued that their share of the management fees paid by each pass-through entity was a separate trade or business and were nonpassive losses. The court held that the management fees were part of the rental activities of the pass-through entities and had to be characterized as passive losses. **Hillman v. Comm'r, 118 T.C. No. 17 (2002)**.

PENALTIES. The IRS has issued a revenue procedure which updates and restates the IRS position regarding the application, by the IRS, of a partial payment of tax, penalty, and interest for one or more taxable periods. This revenue procedure supersedes *Rev. Rul. 73-304, 1973-2 C.B. 42; Rev. Rul. 73-305, 1973-2 C.B. 43; and Rev. Rul. 79-284, 1979-2 C.B. 83*. **Rev. Proc. 2002-26, I.R.B. 2002-15, 746**.

PENSION PLANS. The IRS has adopted as final regulations which provide a uniform (and, arguably simplified) procedure for minimum required distributions from employee pension plans. A table is to be used to determine the minimum distribution required during their lifetime. **Treas. Reg. § 1.401(a)(9)-5, Q&A 4 (26.2 years for those age 70, up to 1.8 years for those 115 and older)**.

For distributions from an individual account, the required minimum distribution is determined by dividing the account balance by the distribution period. **Treas. Reg. § 1.401(a)(9)-5, Q&A 1.** An exception applies if the employee's sole beneficiary is the employee's spouse who is more than 10-years younger than the employee, in which case the employee is allowed to use the longer distribution period measured by the joint life and last survivor life expectancy of the employee and spouse. **Treas. Reg. § 1.401(a)(9)-5, Q&A 5**.

Generally, the designated beneficiary is determined as of September 30 of the year following the year of the employee's death rather than as of the employee's required beginning date or date of death. **Treas. Reg. § 1.401(a)(9)-4, Q&A 4**. Any beneficiary eliminated by the distribution of the benefit or through disclaimer during the period between the employee's death and the end of the year following the year of death is disregarded in determining the employee's designated beneficiary for purposes of calculating the required minimum distribution. ***Id***.

For an employee with a designated beneficiary, the same rules apply for distributions after the employee's death regardless of whether the death occurred before or after the employee's required beginning date. For an employee who elects or defaults into recalculation of life expectancy and dies without a designated beneficiary, the requirement is eliminated that the employee's entire remaining account balance must be distributed in the year after death. Instead, a distribution period equal to the employee's remaining life expectancy recalculated immediately after death applies. The default rule is changed in the case of death before the employee's required beginning date for a nonspouse designated beneficiary from the five-year rule of I.R.C. § 401(a)(9)(B)(ii) to the life expectancy rule of I.R.C. § 401(a)(9)(B)(iii). **Treas. Reg. § 1.401(a)(9)-3, Q&A 1**. Absent a plan provision or election of the five year rule, the life expectancy rule applies in all cases in which the employee has a designated beneficiary.

The designated beneficiary for determining the distribution period for annuity payments generally is the beneficiary as of the annuity starting date, even if that date is after the required beginning date. **Treas. Reg. § 1.401(a)(9)-6**. A beneficiary of a trust is allowed to be an employee's designated beneficiary for purposes of required minimum distributions when the trust is named as the beneficiary of a retirement plan or IRA if the requirements are met. **Treas. Reg. § 1.401(a)(9)-4(c), Q&A 5**. Documentation of the underlying trust beneficiaries must be provided in a timely manner to the plan administrator. ***Id***.

The regulations are applicable for calendar years beginning on or after January 1, 2003. For 2001 and 2002, taxpayers may rely on the new or old regulations. **67 Fed. Reg. 18987 (April 17, 2002).**

TAX LIEN. The taxpayers, husband and wife, owned real property as tenants by the entireties. The IRS filed a tax lien against the property owned by the husband for taxes owed solely by the husband. The taxpayers then transferred the property to the wife solely in her name. The IRS sought to enforce the lien against the proceeds of the sale of the property, arguing that the transfer was fraudulent and subject to the tax lien. The taxpayers argued that the husband had no

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sole property interest under state law in the property held as tenants by the entireties. The U.S. Supreme Court held that the husband had sufficient property interests in the property to which the lien attached. The court pointed out that the husband had several property rights: the right to use the entireties property; the right to exclude others from it, the right of survivorship; the right to become a tenant in common with equal shares upon divorce; the right to sell the property with respondent's consent and to receive half the proceeds from such a sale; the right to encumber the property with respondent's consent; and the right to block respondent from selling or encumbering the property unilaterally; the right to use the entireties property, the right to exclude others from it; the right of survivorship; the right to become a tenant in common with equal shares upon divorce; the right to sell the property with respondent's consent and to receive half the proceeds from such a sale; the right to encumber the property with respondent's consent; and the right to block respondent from selling or encumbering the property unilaterally. The court stated that the husband's inability to unilaterally alienate the property was not sufficient to prevent attachment of the tax lien. **United States v. Craft, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,361 (S. Ct. 2002),** ***rev'g*****, 233 F. 3d 358 (6th Cir. 2000)**.

SAFE HARBOR INTEREST RATES
May 2002

	Annual	Semi-annual	Quarterly	Monthly
Short-term				
AFR	3.21	3.18	3.17	3.16
110 percent AFR	3.53	3.50	3.48	3.47
120 percent AFR	3.86	3.82	3.80	3.79
Mid-term				
AFR	4.99	4.93	4.90	4.88
110 percent AFR	5.49	5.42	5.38	5.36
120 percent AFR	6.01	5.92	5.88	5.85
Long-term				
AFR	5.85	5.77	5.73	5.70
110 percent AFR	6.45	6.35	6.30	6.27
120 percent AFR	7.04	6.92	6.86	6.82

Rev. Rul. 2002-25, I.R.B. 2002-__.

TRUSTS. The taxpayer trust was established in 1945 and had passed through several generations of income beneficiaries. The trustees did not have any financial investment experience and hired outside financial advisors. The trust deducted the cost of the advisors from trust income; however, the IRS disallowed the deduction to the extent it exceeded 2 percent of the trust income. The IRS argued that the expense was a miscellaneous itemized deduction because the expense was not unique to the administration of a trust but was customary for investment of substantial assets. The court noted that Virginia law provided a trustee with absolute immunity from liability for investments made in any of the three statutory assets. See Va. Code § 26-40.01. Therefore, the court held that investment costs were not a unique administrative cost for trusts in Virginia and the costs were subject to the 2 percent of gross income limitation. The case leaves intact the conflict between *Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001)* (trust investment fees subject to 2 percent limitation) and *O'Neill v. Comm'r, 994 F.2d 302 (6th Cir. 1993)* (trust investment costs fully deductible from trust income). **Scott v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,364 (E.D. Va. 2002)**.

WORK CREDIT. Employers or their authorized representatives must submit Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits, to state employment security agencies (SESAs) as part of the process of obtaining the tax credits. The IRS has announced that it will allow for the electronic submission of Forms 8850 with SESAs that establish systems to electronically receive the form. Generally, the electronic system must meet the following requirements: (1) The electronic system must ensure that the information received is the information sent; all occasions of access that result in the submission of a Form 8850 must be documented. Also, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the persons signing and submitting Form 8850 and accessing the system are the job applicant and employer identified in the form. (2) The electronic submission must provide the SESA with the same information as the paper Form 8850. **Ann. 2002-44, I.R.B. 2002-17**.

NEGLIGENCE

TRACTOR. The plaintiff was injured while driving a tractor between one defendant's farm and the other defendant's farm. The defendants owned the tractor and one defendant had started to follow the tractor but turned back because of other business. The tractor was struck from behind by a car, causing the plaintiff's injuries. The plaintiff argued that the defendant had a duty to follow the tractor and to provide the tractor with a rollover protection systems (ROPS). The court held that the plaintiff failed to show that the defendant had assumed any duty to follow the plaintiff and the plaintiff had not relied on the defendant's following the tractor for safety. The court also held that the lack of a ROPS was an open and obvious condition of the tractor and the plaintiff assumed the risk of driving the tractor without a ROPS. **Winn v. Pollard, 62 S.W.3d 611 (Mo. Ct. App. W.D. 2001)**.

CITATION UPDATES

Catalano v. Comm'r, 279 F.3d 682 (9th Cir. 2002), ***rev'g*****, T.C. Memo. 2000-82** (abandonment) see p. 27 *supra*.